

# Proposed FinCen Anti-Money Laundering Rules

Implications for Life Settlement Investment Fund Managers

Authored by: Brian T. Casey and Robert E. Underhill

September 2015

On August 25, 2015, the Financial Crimes Enforcement Network (FinCEN), a bureau of the U.S. Treasury Department, issued for public comment proposed rules requiring investment advisers registered with the Securities and Exchange Commission (the SEC) to establish anti-money laundering (AML) programs and impose reporting obligations with respect to suspicious activity under the Bank Secrecy Act (the Proposed AML Rules).

Depending on the circumstances and availability of exemptions, managers of life settlement investment funds (Fund Managers) may or may not be required to register with the SEC as an investment adviser. Fund Managers that are registered with the SEC will be subject to the Proposed AML Rules, if they are finalized and become effective, which will impose additional regulatory compliance responsibilities on these managers. It is worth noting that the Proposed AML Rules will be applicable to Fund Managers even if they register with the SEC voluntarily or have filed an exemption from registration as an investment adviser with the SEC other than the Venture Capital Exemption or the Private Fund Exemption (as defined below).<sup>1</sup>

## When is a Life Settlement Fund Manager Required to Register as an Investment Adviser?

Under Section 202(a)(11) of the Investment Advisers Act of 1940, as amended (the Advisers Act), an investment adviser is any person that is engaged in the business of rendering advice to others regarding securities in exchange for receiving compensation. Like the question of whether a U.S.-based life settlement fund is an investment company under the Investment Company Act of 1940, as amended, the question of whether a Fund Manager (usually a general partner of a partnership fund) is an investment adviser under the Advisers Act turns on whether the life settlement fund buys, holds and sells securities among the assets in which it invests, namely variable life insurance policies. If a life settlement fund owns any fractional interests in a life insurance policy, regardless of whether such policy is variable or non-variable, the Fund Manager is deemed to hold securities and the Fund Manager would be considered to be an investment adviser subject to the Advisers Act, absent an applicable exclusion from the definition of an investment adviser or applicable exemption.

If a life settlement fund only trades in non-variable life insurance policies, it generally would not be an investment company and its Fund Manager would not be rendering advice to it regarding securities. However, even life settlement funds that invest only in non-variable life insurance policies may be an investment company if they invest idle cash held for future premium payments in securities even for short periods, making the Fund Manager an investment adviser under the Advisers Act. These Fund Managers may have to register with the SEC (or a state securities commission) unless an exemption from registration as an investment advisor is available.

Even where a Fund Manager does not technically meet the definition of an investment adviser or otherwise qualifies for an exemption, some Fund Managers have voluntarily registered with the SEC because of marketplace perceptions and marketing advantages, or, in the case of certain large established asset managers, their registered investment adviser affiliate is used as the Fund Manager as a matter of business practice and investor expectations, especially pension fund investors.

## Registration Requirements and Exemptions

Unless an exclusion from the definition of an investment adviser or exemption from registration as an investment advisor is available to a Fund Manager:

- (1) a large investment adviser, one with more than \$100 million of total assets under management, must register with the SEC;
- (2) a midsize investment adviser, one with total assets under management between \$25 million and \$100 million of total assets under management, must register in all the states in which it transacts business unless it has registered in the state where it has its principal place of business and is subject to examination by that state's securities commission and cannot register with the SEC; and

- (3) a small investment adviser, one with less than \$25 million of total assets under management, must register in all the states in which it transacts business and does not have to register with the SEC unless its principal place of business state does not regulate investment advisers.

Although there are a total of five exemptions from registration under Section 203(b) of the Advisers Act, the following exemptions from registration as an investment adviser are the most common exemptions utilized by Fund Managers, which otherwise meets the definition of an investment adviser:

- any investment adviser: (1) all of whose clients are within the same state as the adviser's principal business office; and (2) that does not provide advice or issue reports about securities listed on any national securities exchange (the Intra-State Adviser Exemption);
- any investment adviser who: (1) has no place of business in the United States; (2) has, in total, fewer than 15 clients in the United States and investors in the United States in private funds advised by the adviser; (3) has aggregate assets under management attributable to these clients and investors of less than \$25 million; and (4) does not hold itself out generally to the public in the United States as an investment adviser (the Foreign Private Adviser Exemption<sup>2</sup>);
- an investment adviser solely to private funds that has less than \$150 million in assets under management in the United States (the Private Fund Exemption); and
- an investment that solely advises one or more venture capital funds, regardless of the amount of assets managed (the Venture Capital Exemption)

It is important to note that several Fund Managers without a place of business in the United States<sup>3</sup>, but have clients and/or investors in life settlement funds, are not likely to be able to avail themselves of the Foreign Private Adviser Exemption because of the exemption's narrow application, the limitation on both the number of clients and investors in the United States as well as the limitation on the amount of assets attributable to such clients and investors, and the need to continually monitor the amount of assets under management render the Foreign Private Adviser Exemption of limited use for many foreign Fund Managers. For those foreign Fund Managers that do not qualify for the Foreign Private Adviser Exemption, but which manage only private funds with United States investors, the Private Fund Exemption may be a more practical exemption to claim. Under the Private Fund Exemption, a foreign Fund Manager is permitted to manage an unlimited amount of qualifying private fund assets provided its principal office and place of business is outside the United States and it does not manage any assets for U.S. persons other than qualifying private funds, without regard to the number of non-U.S. clients or the amount of assets managed outside the United States.

A Fund Manager is not regulated by the Advisers Act if it is excluded from the definition of an investment adviser as: (1) a broker or a dealer registered with the SEC under the Securities and Exchange Act of 1934, as amended, the advice of which is incidental to the conduct of its business as broker or dealer and does not result in special compensation to the broker-dealer; or (2) a family office that manages the wealth and other affairs of a single family. While Fund Managers that are excluded from the definition of an investment adviser do not need to comply with the Proposed AML Rules, Fund Managers, which have filed exemptions from registration with the SEC as an investment adviser are subject to and must comply with the Proposed AML Rules, unless the Fund Manager is an exempt reporting adviser, which is defined as an investment adviser which relies on either the Venture Capital Exemption or the Private Fund Exemption. Although filing an exemption is voluntary, Fund Managers which voluntarily register under an exemption in accordance with the Advisers Act under any exemption other than the Venture Capital and Private Fund Exemptions in circumstances where their registration may not be required, are subject to all of the provisions and rules under the Advisers Act applicable to persons required to register as an investment adviser.

State regulatory law is not preempted for a Fund Manager taking advantage of one of the exceptions from registration and thus a Fund Manager subject to a recognized exemption from registration under the Advisers Act may be required to register with one or more state securities regulators.

### Summary of the Proposed AML Rules

The Proposed AML Rules apply to all Fund Managers that are either registered or required to be registered with the SEC pursuant to Section 203 of the Advisers Act as an investment advisor. The Proposed AML Rules will require these Fund Managers to establish effective AML programs akin to what is already required for banks, broker-dealers, life insurance companies and certain other types of financial institutions. The Proposed AML Rules also will require Fund Managers to report suspicious activity to FinCEN pursuant to the Bank Secrecy Act.

The AML program must be "reasonably designed" to prevent the Fund Manager from facilitating money laundering or the financing of terrorist activities. The Proposed AML Rules set forth four minimum standards, generally known as the "four pillars," that an effective AML program must satisfy. The four pillars are: (1) written policies, procedures and internal controls; (2) independent testing; (3) designated compliance officer that is knowledgeable and competent on AML requirements; and (4) ongoing training. The AML

(3) designated compliance officer that is knowledgeable and competent on AML requirements; and (4) ongoing training. The AML program must be approved in writing by the board of directors, trustees or similar authority of the Fund Manager.

Fund Managers that are subject to the Proposed AML Rules would be subject to the same civil and criminal penalties that are currently applicable to banks, insurance companies and other financial institutions. These penalties can include civil monetary penalties of up to \$100,000 for each day that the Fund Manager is in violation of the Proposed AML Rules. The criminal penalties include monetary penalties of up to \$250,000 and up to five years imprisonment (and these amounts can be doubled if the violation includes other violations of law or a pattern of criminal activity). It is worth noting that criminal charges can be brought against employees of the Fund Manager (including the AML compliance officer) as well as the institution itself.

The Proposed AML Rules are still subject to a public comment period that will end on November 2, 2015. Under the Proposed AML Rules, Fund Managers subject to the rules will need to have an AML program in place (and begin filing suspicious activity reports) within six months of the effective date of the Proposed AML Rules. Accordingly, it is possible that Fund Managers could be required to have an effective AML program in place as soon as May 2016. Fund Managers would be well advised to begin reviewing their existing compliance programs to ensure that they will be in a position to implement an effective compliance program on a timely basis. Fund Managers should also review their existing investor disclosure documentation to determine if amendments are necessary.

### Endnotes

- 1 Investment advisers that rely on the Venture Capital and Private Fund Adviser exemptions are considered exempt reporting advisers, to which the Proposed AML Rules do not apply; an investment adviser with any other exemption under Section 203 of the Adviser's Act must comply with the Proposed AML Rules.
- 2 The exemption for foreign private advisers was added by the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) and replaces the private adviser exemption (i.e., an exemption for any adviser with fewer than 15 clients) previously provided by the same section of the Advisers Act, which was repealed.
- 3 Rule 202(a)(30)-1 under the Advisers Act defines place of business "to mean any office where the investment adviser regularly provides advisory services, solicits, meets with, or otherwise communicates with clients, and any location held out to the public as a place where the adviser conducts such activities."

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## ABOUT THE AUTHORS



**Brian T. Casey**

Partner  
Atlanta  
404-870-4638  
[bcasey@lockelord.com](mailto:bcasey@lockelord.com)

**Brian Casey** focuses on corporate, merger and acquisition, corporate and structured finance and other transactional, and regulatory matters for corporate clients in the insurance, financial services and health care industries. One significant facet to Brian's practice is a focus on insurance-linked securities and related insurance capital markets transactions. His clients include insurance companies, insurance holding companies, managing general agents and insurance agencies, third party and claims administrators, banks and other financial institutions, investment banks and reinsurance companies.



**Robert E. Underhill**

Partner  
New York  
212-912-2733  
[robert.underhill@lockelord.com](mailto:robert.underhill@lockelord.com)

**Robert Underhill** has over two decades of experience representing insurers and reinsurers, investment banks and alternative investment advisors in insurance-related transactions involving both life and property & casualty risks. Robert has been involved in many of the transformational transactions in the industry including the first pension de-risking swap, early longevity swaps, various investments involving premium finance and life settlements, life insurance carrier demutualizations, life insurance and annuity securitizations and the first negative interest rate bond for an insurance company.



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